

FIRST 5
Santa Clara County
(A Component Unit of the County of Santa Clara, California)

**Independent Auditors' Reports, Management's Discussion
and Analysis, Basic Financial Statements, and
Required Supplementary Information**

For the Fiscal Years Ended June 30, 2006 and 2005

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INDEPENDENT AUDITORS' REPORT

August 6, 2006

To FIRST 5 Santa Clara County
San Jose, California

We have audited the accompanying basic financial statements of FIRST 5 Santa Clara County (Commission), a component unit of the County of Santa Clara, California, as of and for the year ended June 30, 2006 as listed in the Table of Contents. These financial statements are the responsibility of the Commission's management. Our responsibility is to express an opinion on these financial statements based on our audit. The 2005 financial statements were audited by Brach, Neal, Daney & Spence, LLP who merged with Burr, Pilger & Mayer, LLP as of July 1, 2006. Their report dated September 7, 2005 issued an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Commission as of June 30, 2006, and the changes in its financial position for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with Government Auditing Standards, we have also issued a report dated August 6, 2006, on our consideration of the Commission's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be considered in assessing the results of our audit.

The Management's Discussion and Analysis on pages 3 through 6 and the Schedule of Statement of Activities - Budget and Actual on page 22 are not a required part of the basic financial statements, but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

BURR, PILGER & MAYER LLP

Burr, Pilger & Mayer LLP

FIRST 5
SANTA CLARA COUNTY
MANAGEMENT'S DISCUSSION AND ANALYSIS
June 30, 2006

FIRST 5 Santa Clara County was formed when voters approved Proposition 10 in November 1998, adding an additional excise tax on cigarettes and tobacco related products to fund programs that promote, support and improve early childhood development, for children prenatal through five years of age and their families. Proposition 10 was designed to address the lack of public funding and support for early childhood development in the wake of a growing body of scientific evidence indicating that the emotional, physical, and intellectual environment that a child is exposed to prior to five years of age has a profound impact on how his/her brain develops. The goal is for all young children in California to reach age five physically healthy and to enter school ready to learn.

In March 1999 the Santa Clara County (County) Board of Supervisors created the nine-member FIRST 5 Santa Clara County (FIRST 5) Commission. FIRST 5 is a public entity legally separate and apart from the County, and is considered a component unit of the County due to the operational relationship between FIRST 5 and the County.

Our Community Investment Strategy is based on extensive research and Community feedback, which resulted in the commission developing a clear strategy for making sound funding decisions for the programs and services offered at FIRST 5. The funding strategy is consistent with the Vision, Mission and Goals of the Organization and meets the FIRST 5 California mandate for serving all children prenatal through age 5. The programs and services offered by FIRST 5 Santa Clara County are grounded in research and evidenced based practices. The Commission adopted two funding strategies under which all investments were aligned:

Community Engagement and Education (Countywide)
High Risk (Targeted Impact)

These Primary strategies provide for continued funding of countywide programs designed to serve all children in the County, prenatal through age 5 and target impact programs that focus on children and families in specific communities and/or regions of the County. These strategies allow FIRST 5 to direct resources to reach children prenatal through age 5 throughout Santa Clara County, while demonstrating improved outcomes of children with high cumulative risk factors in targeted communities with the largest number of children prenatal through age 5. FIRST 5 Santa Clara County is committed to ensuring that effective programs and services to young children and their families are in place and sustainable.

As management of FIRST 5, we offer readers of our FIRST 5 financial statements this narrative overview and analysis of the financial activities for the fiscal year ended June 30, 2006.

Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to FIRST 5's basic financial statements. FIRST 5's basic financial statements comprise three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements. This report also contains other supplementary information in addition to the basic financial statements themselves.

FIRST 5
SANTA CLARA COUNTY
MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
June 30, 2006

Government-wide Financial Statements. The government-wide financial statements are designed to provide readers with a broad overview of FIRST 5's finances, in a manner similar to private sector business. As such, FIRST 5 has recently adopted this format for their internal reporting.

The Statement of Net Assets presents information on all of FIRST 5's assets and liabilities, with the difference between the two reported as net assets.

The Statement of Activities presents information showing how FIRST 5's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Thus, revenues and expenses are reported in the statement for some items that will only result in cash flows in future fiscal periods (e.g. earned but unused vacation leave). The government-wide financial statements can be found on pages 7 and 8 of this report.

Fund Financial Statements. A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. Fund financial statements report essentially the same functions as those reported in the government-wide financial statements. However, unlike the government-wide financial statements, fund financial statements focus on near-term inflows and outflows of spendable resources, as well as on balances of spendable resources available at the end of the fiscal year.

Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures, and changes in fund balance provide a reconciliation to facilitate the comparison between governmental funds and government-wide statements. The fund financial statements can be found on pages 9 and 10 of this report.

Notes to Financial Statements. The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found on pages 11-21 of this report.

Government-wide Financial Analysis

FIRST 5 uses government-wide financial reporting to provide a broad overview in a manner similar to the private sector. In most cases, net assets may serve over time as a useful indicator of a government's financial position. In the case of FIRST 5, assets exceeded liabilities by \$95.8 million at the close of the most recent fiscal year. The most significant portion of FIRST 5's current assets of \$95.2 million is its cash and investments balance of \$89.9 million. This represents resources received from the State Commission from Proposition 10 taxes that have not been expended. The majority of cash and investments are maintained by Merrill Lynch where interest earned is reinvested. The balance of cash is maintained in the County's cash and investment commingled pool where interest earned on FIRST 5's balance is apportioned to FIRST 5. Another source of current assets resides in FIRST 5's receivables due from the State Commission for Proposition 10 tax revenue. These receivables of \$4.8 million represent taxes remitted by the State but not received by FIRST 5 as of June 30, 2006.

FIRST 5 also reports total liabilities of \$5.8 million of which accounts payable represents \$5.4 million, primarily representing payments due on grant service contracts that had not been disbursed at year-end.

FIRST 5 net assets of \$95.8 million decreased by \$2.3 million or 2.4% from the prior fiscal year.

FIRST 5
SANTA CLARA COUNTY
MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
June 30, 2006

FIRST 5 Santa Clara County
Condensed Statement of Net Assets

	<u>FY 2005/06</u>	<u>FY 2004/05</u>	<u>% Change</u>
Assets:			
Current and Other Assets	\$ 95,166,828	\$ 104,825,214	-9.2%
Capital Assets	6,499,445	1,696,400	283.1%
Total Assets	<u>101,666,273</u>	<u>106,521,614</u>	4.6%
Total Liabilities	5,837,350	8,385,034	-30.3%
Net Assets:			
Invested in Capital Assets	6,499,445	1,696,400	283.1%
Restricted	89,329,478	96,440,180	7.4%
Total Net Assets	<u>\$ 95,828,923</u>	<u>\$ 98,136,580</u>	2.4%

FIRST 5 Santa Clara County
Condensed Statement of Activities

	<u>FY 2005/06</u>	<u>FY 2004/05</u>
Total Revenue	\$ 28,009,348	\$ 30,341,221
Expenses:		
Salaries, Supplies & Service	6,745,049	7,685,357
Grant Expenses	23,571,956	23,110,772
Total Expenses	<u>30,317,005</u>	<u>30,796,129</u>
Change in Net Assets	<u>\$ (2,307,657)</u>	<u>\$ (454,908)</u>

Total revenue consisting of Proposition 10 funds, interest, rental and investment income, State Commission matching and Foundation grants slightly decreased from \$30.3 million to \$28.0 million for the year ended June 30, 2006. This decrease was primarily due to a reduction in the Proposition 10 revenue and the interest and investment income.

Total expenditures decreased to \$30.3 million, a decrease of \$479 thousand from the prior year. This decrease is primarily due to lower operating expenses.

For the fiscal year ended June 30, 2006, FIRST 5 reported a change in net assets of \$2.3 million from the prior year. This decrease represents the amount of expenditures in excess of revenues for the period ended June 30, 2006.

FIRST 5
SANTA CLARA COUNTY
MANAGEMENT'S DISCUSSION AND ANALYSIS (Continued)
June 30, 2006

Governmental Activities. FIRST 5 does not have business type activities and so the analysis presented above for the government-wide financial statements also represents an analysis of FIRST 5's governmental activities.

Financial Analysis of FIRST 5's Governmental Fund. For fiscal year ended June 30, 2006, FIRST 5 reported an ending fund balance of \$89.5 million, a decrease of \$7.1 million from the prior year. FIRST 5 has committed 88.7% of the \$89.5 million as shown below:

FIRST 5 Santa Clara County
Committed Funds
Fiscal Year 2005/2006

Encumbrances	\$	1,216,904
Approved Contracts Not Yet Executed (Obligation)		28,036,349
Funds Invested in Capital Assets		6,499,445
Reserved for First 5 California Initiatives		9,367,739
Reserved for Program Sustainability		30,945,572
Reserved for Local Initiatives		3,333,651
Total Committed Funds	\$	79,399,660

In broad terms, “committed funds” represent the portion of the fund balance that have been set aside for programs, projects, and activities to be conducted in the future according to our Community Investment Strategy & Budget formally approved by our FIRST 5 County Commission. As a result these funds are unavailable for uses other than the purposes for which they were designated.

Budgetary Highlights

Total expenditures were \$7.9 million less than budget due to the delay in start-up time for funded programs and initiatives that were awarded in fiscal year ended June 30, 2006.

Capital Assets and Debt Administration

Capital assets. FIRST 5's capital assets for its governmental activities as of June 30, 2006, amounted to \$6.5 million (net of accumulated depreciation). Capital assets include the purchase of our new building, furniture and equipment. See Note 3 to the Notes to the Financial Statements for a more detailed analysis of changes in capital assets.

Debt administration. At the end of the current fiscal year, FIRST 5 did not have any long-term obligations outstanding.

Requests for Information

This financial report is designed to provide a general overview of FIRST 5 Santa Clara County's finances for all those interested. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to FIRST 5 Santa Clara County, 4000 Moorpark Ave., Suite 200, San Jose, California 95117.

FIRST 5
SANTA CLARA COUNTY
STATEMENT OF NET ASSETS
June 30, 2006 and 2005

ASSETS

	2006	2005
Cash and investments	\$ 89,855,118	\$ 99,203,847
Interest receivable	398,860	533,122
Grant and other receivable	50,965	84,363
Due from the State - Proposition 10	4,827,153	4,978,862
Prepays and other assets	34,732	25,020
Capital assets, net of depreciation	6,499,445	1,696,400
Total assets	\$ 101,666,273	\$ 106,521,614

LIABILITIES AND NET ASSETS

Accounts payable	\$ 5,362,682	\$ 8,037,562
Accrued salaries and benefits	201,069	194,630
Accrued vacation payable	177,991	152,842
Other accrued liabilities	95,608	-
Total liabilities	5,837,350	8,385,034
Net Assets:		
Invested in capital assets	6,499,445	1,696,400
Restricted	89,329,478	96,440,180
Total net assets	\$ 95,828,923	\$ 98,136,580

See accompanying notes to basic financial statements.

FIRST 5
SANTA CLARA COUNTY
STATEMENT OF ACTIVITIES
For the Years Ended June 30, 2006 and 2005

	2006	2005
FIRST 5 Program Expenses:		
Salaries and benefits	\$ 4,498,434	\$ 4,390,148
Supplies and services	2,019,811	3,248,760
Grant expenditures	23,571,956	23,110,772
Depreciation	226,804	46,449
Total Program Expenses	30,317,005	30,796,129
Program Revenue:		
Operating grants and contributions		
Proposition 10 taxes	23,406,400	24,268,679
Foundation and state matching grants	2,091,587	2,865,232
Total Program Revenues	25,497,987	27,133,911
Net Program Revenue (Expenses)	(4,819,018)	(3,662,218)
General Revenue		
Investment income	2,197,111	3,001,872
Rental income	86,585	-
Other income	227,665	205,438
Total Program Services	2,511,361	3,207,310
Change in net assets	(2,307,657)	(454,908)
Net assets, beginning of year	98,136,580	98,591,488
Net assets, end of year	\$ 95,828,923	\$ 98,136,580

See accompanying notes to basic financial statements.

FIRST 5
SANTA CLARA COUNTY
BALANCE SHEET - GOVERNMENTAL FUND
June 30, 2006 and 2005

ASSETS

	2006	2005
Cash and investments	\$ 89,855,118	\$ 99,203,847
Interest receivable	398,860	533,122
Grant and other receivable	50,965	84,363
Due from the State - Proposition 10	4,827,153	4,978,862
Prepays and other assets	34,732	25,020
Total assets	\$ 95,166,828	\$ 104,825,214

LIABILITIES AND FUND BALANCE

Liabilities:		
Accounts payable	\$ 5,362,682	\$ 8,037,562
Accrued salaries and benefits	201,069	194,630
Other accrued liabilities	95,608	-
Total liabilities	5,659,359	8,232,192
Fund Balance:		
Reserved for encumbrances	1,216,904	5,339,890
Unreserved:		
Designated for School Readiness, Regional Partnership and Other Programs	40,737,739	28,445,352
Undesignated	47,552,826	62,807,780
Total fund balance	89,507,469	96,593,022
Total liabilities and fund balance	\$ 95,166,828	\$ 104,825,214

RECONCILIATION OF THE BALANCE SHEET - GOVERNMENTAL
FUND TO THE STATEMENT OF NET ASSETS

Fund balance - from above	\$ 89,507,469	\$ 96,593,022
Amount reported in the Statement of Net Assets are different because:		
Capital assets used in governmental activities are not financial resources and, therefore, are not reported in the governmental funds.	6,499,445	1,696,400
Accrued vacation payable is not due and payable with current financial resources and is not reported in the governmental funds.	(177,991)	(152,842)
Net Assets	\$ 95,828,923	\$ 98,136,580

See accompanying notes to basic financial statements.

FIRST 5
SANTA CLARA COUNTY
STATEMENT OF REVENUES, EXPENDITURES AND
CHANGES IN FUND BALANCE - GOVERNMENTAL FUND
For the Years Ended June 30, 2006 and 2005

	2006	2005
Revenues:		
Proposition 10 taxes	\$ 23,406,400	\$ 24,268,679
Foundation and state matching grants	2,091,587	2,865,232
Investment income	2,197,111	3,001,872
Rental income	86,585	-
Other revenue	227,665	205,438
	28,009,348	30,341,221
Expenditures:		
Current:		
Salaries and benefits	4,473,285	4,365,921
Supplies and services	2,019,811	3,248,760
Grant expenditures	23,571,956	23,110,772
Capital outlay	5,029,849	1,683,382
	35,094,901	32,408,835
Change in fund balance	(7,085,553)	(2,067,614)
Fund balance, beginning of year	96,593,022	98,660,636
Fund balance, end of year	\$ 89,507,469	\$ 96,593,022

RECONCILIATION OF THE STATEMENT OF REVENUES, EXPENDITURES,
AND CHANGE IN FUND BALANCE - GOVERNMENTAL FUND TO THE
STATEMENT OF ACTIVITIES

Net change in fund balance - from above	\$ (7,085,553)	\$ (2,067,614)
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Amount reported in the Statement of Activities
are different because:

Governmental funds report capital outlay as expenditures.

However, in the Statement of Activities, the cost of
those assets is allocated over their estimated useful
lives and reported as depreciation expense.

Expenditures for general capital assets	5,029,849	1,683,382
Less current year depreciation	(226,804)	(46,449)

The change in accrued vacation payable reported
in the Statement of Activities does not require
the use of current financial resources and
therefore is not reported as expenditures in
governmental funds.

	(25,149)	(24,227)
Change in Net Assets	\$ (2,307,657)	\$ (454,908)

See accompanying notes to basic financial statements.

FIRST 5
SANTA CLARA COUNTY
NOTES TO BASIC FINANCIAL STATEMENTS
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity

The Santa Clara County Board of Supervisors created the Commission on March 30, 1999, under the provisions of the Act. The Act became law in 1998 when California (State) voters approved Proposition 10, authorizing the State to levy a tax on tobacco products to pay for programs to promote the healthy development of young children. The Commission is a public entity legally separate and apart from the County. The purpose of the Commission is to develop, adopt, promote and implement early childhood development programs in the County consistent with the goals and objectives of the Act. The Commission's programs are funded by the taxes imposed by Proposition 10.

The Commission consists of nine members appointed by the County Board of Supervisors. The Commission is considered a component unit of the County due to the operational relationship between the Commission and the County; therefore, the Commission's financial statements are included in the County's Comprehensive Annual Financial Report.

Governmental Accounting Standards Board Statements and Interpretation

The financial statements are prepared in accordance with GASB Statement No. 34. This statement affects the manner in which the Commission records transactions and presents financial information.

Management's Discussion and Analysis - GASB Statement No. 34 requires that financial statements be accompanied by a narrative introduction and analytical overview of the Commission's financial activities in the form of "management's discussion and analysis" (MD&A). This analysis is similar to the analysis provided in the annual reports of private-sector organizations.

Government-wide Financial Statements - The reporting model includes financial statements prepared using full accrual accounting for all of the Commission's activities. This approach includes not just current assets and liabilities but also capital and other long-term assets as well as long-term liabilities. Accrual accounting also reports all of the revenues and costs of providing services each year, not just those received or paid in the current year or soon thereafter.

Statement of Net Assets - The Statement of Net Assets is designed to display the financial position of the government. The net assets of the Commission are broken down into two categories - invested in capital assets and restricted.

Statement of Activities - The Statement of Activities reports expenses and revenues in a format that focuses on the cost of the Commission's function. The expense of individual functions is compared to the revenue generated directly by the function.

FIRST 5
SANTA CLARA COUNTY
NOTES TO BASIC FINANCIAL STATEMENTS
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Governmental Accounting Standards Board Statements and Interpretation (Continued)

Accordingly, the Commission has recorded certain other long-term assets and liabilities in the Statement of Net Assets, and has reported all revenues and the cost of providing services under the accrual basis of accounting in the Statement of Activities.

Statement No. 38. The Commission adopted the provisions of GASB Statement No. 38, "Certain Financial Statement Note Disclosures." This statement modifies, establishes and rescinds certain financial statement disclosure requirements. Accordingly, certain footnote disclosures have been revised to conform to the provisions of GASB Statement No. 38.

Interpretation No. 6. The Commission adopted the provisions of GASB Interpretation No. 6, "Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements." This interpretation clarifies the application of standards for modified accrual recognition of certain liabilities and expenditures in areas where differences have arisen, or potentially could arise, in interpretation and practice. This interpretation impacts the fund level financial statements required by GASB Statement No. 34 but has no direct impact on the government-wide financial statements.

Basis of Presentation and Accounting

Government-wide Financial Statements

The Statement of Net Assets and Statement of Activities display information about the primary government (Commission). These statements include the financial activities of the overall government.

The Statement of Activities presents a comparison between direct expenses and program revenues for the Commission's governmental activity. Direct expenses are those that are specifically associated with the Commission. Program revenues include grants and contributions that are restricted to meeting the operational or capital requirements of the Commission. Revenues that are not classified as program revenues, including investment income, are presented instead as general revenues.

The government-wide financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded at the time liabilities are incurred, regardless of when the related cash flows take place. Nonexchange transactions, in which the Commission gives (or receives) value without directly receiving (or giving) equal value in exchange, include Proposition 10 taxes, grants, entitlements and donations. Revenues from Proposition 10 taxes are recognized when all eligibility requirements are met which coincides with the State apportioning Proposition 10 tax revenues to the Commission. Revenues from grants, entitlements and donations are recognized in the fiscal year in which all eligibility requirements have been satisfied.

FIRST 5
SANTA CLARA COUNTY
NOTES TO BASIC FINANCIAL STATEMENTS
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Government-wide Financial Statements (Continued)

Separate financial statements are provided for the governmental fund. The governmental fund financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting.

Under this method, revenues are recognized when measurable and available to finance expenditures of the current period. Proposition 10 apportionments, grant revenues and investment income are accrued when their receipt occurs within ninety days after the end of the accounting period so as to be both measurable and available. All receivables are expected to be collected within the current year. Expenditures are generally recorded when a liability is incurred, under the accrual basis of accounting. In the current year, the bulk of the accounts payable balance (approximately 94% and 90% at June 30, 2006 and 2005, respectively) relates to payables owed to contractors used in the operation of the Commission's programs. The balance relates to miscellaneous accounts payable. General capital assets acquisitions are reported as expenditures in the governmental fund.

Non-current Governmental Assets/Liabilities

GASB Statement No. 34 eliminates the presentation of account groups, but provides for these records to be maintained and incorporates the information into the Government-wide Statement of Net Assets.

Accounts Receivable

Significant receivables included amounts due from the State of California for Proposition 10 taxes and the County of Santa Clara for earnings on commission funds held in the County's commingled pool. These receivables are due within one year.

The Commission utilizes the allowance method for recognizing bad debts. Management has determined that no allowance for bad debt is required.

Capital Assets

This includes furniture and equipment, building and building improvements that are reported as governmental activity in the Statement of Net Assets. Capital assets are defined as assets with an initial individual cost of \$5,000 or more and an estimated useful life in excess of one year. Donated capital assets are recorded at estimated fair market value at the date of donation. Furniture and equipment, building and building improvements are depreciated using the straight-line method over the following estimated useful lives:

Furniture and equipment	5 years
Building	20 years
Building improvements	20 years

FIRST 5
SANTA CLARA COUNTY
NOTES TO BASIC FINANCIAL STATEMENTS
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Accrued Vacation and Sick Leave Pay

Vacation pay, which may be accumulated up to six weeks, depending on the employee's length of service, is payable upon termination.

Sick leave accrues at approximately 3 hours per pay period and is not limited by how much may be accumulated. Sick leave earned is non-vesting and employees are not reimbursed for accumulated sick leave upon termination.

The Commission accrues for all salary-related items in the government-wide financial statements for which they are liable to make a payment directly and incrementally associated with payments made for compensated absences on termination. The Commission includes its share of Social Security and Medicare payments made on behalf of the employees in its accrual for vacation.

Foundation Grants

Foundation grants include funds received from 501(c)(3) not-for-profit and community based organizations to promote the Commission's stated objectives.

Estimates

The preparation of basic financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

Budget and Budgetary Reporting

The Commission is required to prepare a budget each year based on estimates of revenues and expected expenditures. The budget is adopted on a basis consistent with GAAP. Budgetary control is exercised at the major object level. All changes to the budget during the year require the approval of the Commission. All unencumbered annual appropriations lapse at the end of each fiscal year.

Reservations of Fund Balance

Reservations of fund balance of the governmental fund indicate that portion of fund equity which is not available for appropriation for expenditure or is legally segregated for a specific future use. Following is a description of the nature of certain reserves.

Reserve for Encumbrances - A reserve is set aside for certain contractual obligations that the Commission has with its sub-recipients in the operation of programmatic activities. These obligations in the current year do not constitute expenditures or liabilities, but once the sub-recipient fulfills certain eligibility requirements, will represent expenditures or liabilities.

FIRST 5
SANTA CLARA COUNTY
NOTES TO BASIC FINANCIAL STATEMENTS
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005

NOTE 2 - CASH AND INVESTMENTS

The Commission had the following cash and investments at June 30:

	<u>2006</u>	<u>2005</u>
<u>Cash:</u>		
Commercial Banks	\$ 3,040,687	\$ 3,196,450
County Commingled Pool	35,685,840	65,541,386
	<u>38,726,527</u>	<u>68,737,836</u>
 <u>Investments:</u>		
U.S. Treasuries	\$ 13,067,266	\$ 9,022,105
U.S. Agencies	22,448,422	11,929,400
Corporate Bonds	14,782,550	9,097,129
Money Funds	339,694	123,366
Accrued Interest	490,659	294,011
	<u>51,128,591</u>	<u>30,466,011</u>
 Total Cash and Investments	 <u>\$ 89,855,118</u>	 <u>\$ 99,203,847</u>

At June 30, 2006 and 2005, cash and investments of \$35,685,840 and \$65,541,386 are held in the County's commingled pool, which is managed by the County Treasurer. The difference between cash held in the County Treasury and cash recorded on the Commission's books as being held by the County Treasurer is reflective of checks outstanding that have been recorded on the Commission's books, but not recorded by the County. The County's Treasury Oversight Committee is responsible for the regulatory oversight of the commingled pool. The County reports all of its investments, including the investments of its commingled pool, at fair value. The County Treasurer determines the fair value of the pool on a monthly basis, based on quoted market prices. The value of the pooled shares that may be withdrawn is based upon amortized cost, which is different than the fair value. Realized and unrealized earnings and losses are allocated annually to commingled investment pool participants based on the participants' average daily cash balance relative to the entire pool. Information regarding the County's cash and investments, including custodial risk categories, collateral, and maturities, can be found in the Notes of the County's basic financial statements. The Commission also maintains cash in separate bank accounts. The Commission's carrying amount for its cash recorded in separate bank accounts was \$3,040,688 and \$3,196,450 for the years ended June 30, 2006 and 2005, respectively. The Commission maintains its cash and cash equivalents in commercial checking and money market accounts. Periodically throughout the year, cash is maintained at the various banks in excess of insured (FDIC) amounts of \$100,000.

FIRST 5
SANTA CLARA COUNTY
NOTES TO BASIC FINANCIAL STATEMENTS
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005

NOTE 2 - CASH AND INVESTMENTS - (Continued)

Cash and investment income/(loss) at June 30, 2006 and 2005 is as follows:

	2006	2005
Realized gain/(loss) on matured/ sold investments	\$ (89,906)	\$ (169,406)
Unrealized gain/(loss) in changes in fair value of investments	(980,598)	12,626
Net gain/(loss)	(1,070,504)	(156,780)
Interest income	3,267,615	3,158,652
Total investment income	\$ 2,197,111	\$ 3,001,872

Risk Disclosures:

Interest Rate Risk - The Commission utilizes Merrill Lynch to manage its investment portfolio of Government and Corporate bonds in accordance with the Commission's investment policy. The policy's three main objectives include: safeguarding of principal, meeting the liquidity needs of the Commission, and achieving a competitive rate of return. The Commission's policy indicates all eligible investments and requirements must comply with Government Code Section 53635.2.

As of June 30, 2006, the Commission had the following investments and maturities:

Investment Type	Fair Value	Less than 1 Year	1 - 5 Years
U.S. Treasuries	\$ 13,067,266	\$ 3,225,105	\$ 9,842,161
U.S. Agencies	22,448,422	6,501,288	15,947,134
Corporate Bonds	14,782,550	4,989,907	9,792,643
Money Funds	339,694	339,694	-
Accrued Interest	490,659	490,659	-
	\$ 51,128,591	\$ 15,546,653	\$ 35,581,938

As of June 30, 2005, the Commission had the following investments and maturities:

Investment Type	Fair Value	Less than 1 Year	1 - 5 Years
U.S. Treasuries	\$ 9,022,105	\$ 4,037,360	\$ 4,984,745
U.S. Agencies	11,929,400	-	11,929,400
Corporate Bonds	9,097,129	1,013,680	8,083,449
Money Funds	123,366	123,366	-
Accrued Interest	294,011	294,010	-
	\$ 30,466,011	\$ 5,468,416	\$ 24,997,594

FIRST 5
SANTA CLARA COUNTY
NOTES TO BASIC FINANCIAL STATEMENTS
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005

NOTE 2 - CASH AND INVESTMENTS - (Continued)

Risk Disclosures (Continued):

Credit Risk - State law limits investments in commercial paper and corporate bonds to the top two ratings issued by nationally recognized statistical rating organizations (NRSRO's). At June 30, 2006, the Commission's credit risks, expressed on a percentage basis, are as follows:

Investment Type	Credit Quality Rating		Fair Value at June 30, 2006	% of Investment
	Moody	S&P		
<i>U.S. Treasury:</i>				
U.S. Treasury Notes	AAA	AAA	\$ 13,067,266	25.6%
<i>U.S. Agency Bond:</i>				
Federal Farm Credit Bank (FFCB)	AAA	AAA	4,343,366	8.5%
Federal Home Loan Mortgage Coproration (FHLMC)	AAA	AAA	6,501,289	12.7%
Federal Home Loan Bank (FHLB)	AAA	AAA	1,920,000	3.8%
Federal National Mortgage Assocition (FNMA)	AAA	AAA	9,683,766	18.9%
<i>Corporate Bonds:</i>				
IBM CORP	A1	A+	1,747,234	3.4%
Bell South Corp	A2	A+	1,497,135	2.9%
Wachovia Corporation	AA3	A+	1,745,538	3.4%
Wal-Mart Stores	AA2	AA	1,728,370	3.4%
Goldman Sachs Group, Inc.	AA3	A+	1,712,533	3.3%
Wells Fargo Company	AA1	A-	1,446,600	2.8%
Household Finance Corp.	AA	AA-	1,760,763	3.4%
Citigroup Incl.	AA1	AA-	1,443,255	2.8%
General Electric Cap Cor	AAA	AAA	1,701,123	3.3%
Money Funds	Not Rated		339,694	
Accrued Interest	Not Rated		490,659	
			<u>\$ 51,128,591</u>	

FIRST 5
SANTA CLARA COUNTY
NOTES TO BASIC FINANCIAL STATEMENTS
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005

NOTE 3 - CAPITAL ASSETS

The following is a summary of changes in the capital assets for the year ended June 30, 2006 and 2005:

Governmental Activities

	Balance July 1, 2005	Additions	Retirements	Balance June 30, 2006
Furniture and equipment	\$ 457,731	\$ -	\$ (192,730)	\$ 265,001
Building improvements	1,401,050	175,214	(311,399)	1,264,865
Building	-	3,000,908	-	3,000,908
Land	-	2,357,856	-	2,357,856
Total	<u>\$ 1,858,781</u>	<u>\$ 5,533,978</u>	<u>\$ (504,129)</u>	<u>\$ 6,888,630</u>
Less accumulated depreciation for:				
Furniture and equipment	\$ 156,162	\$ 39,091	\$ -	\$ 195,253
Building improvements	6,219	62,675	-	68,894
Building	-	125,038	-	125,038
Accumulated depreciation	<u>\$ 162,381</u>	<u>226,804</u>	<u>-</u>	<u>389,185</u>
Total capital assets, net	<u>\$ 1,696,400</u>	<u>\$ 5,307,174</u>	<u>\$ (504,129)</u>	<u>\$ 6,499,445</u>

Governmental Activities

	Balance July 1, 2004	Additions	Retirements	Balance June 30, 2005
Furniture and equipment	\$ 175,398	\$ 282,333	\$ -	\$ 457,731
Leasehold improvements	96,987	-	(96,987)	-
Building improvements	-	1,401,050	-	1,401,050
Total	<u>\$ 272,385</u>	<u>\$ 1,683,383</u>	<u>\$ (96,987)</u>	<u>\$ 1,858,781</u>
Less accumulated depreciation for:				
Furniture and equipment	\$ 115,934	\$ 40,228	\$ -	\$ 156,162
Leasehold improvements	96,984	-	(96,984)	-
Building improvements	-	6,219	-	6,219
Accumulated depreciation	<u>212,918</u>	<u>46,447</u>	<u>(96,984)</u>	<u>\$ 162,381</u>
Total capital assets, net	<u>\$ 59,467</u>	<u>\$ 1,636,936</u>	<u>\$ (3)</u>	<u>\$ 1,696,400</u>

FIRST 5
SANTA CLARA COUNTY
NOTES TO BASIC FINANCIAL STATEMENTS
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005

NOTE 3 - CAPITAL ASSETS - (Continued)

Depreciation is allocated in total to the Commission's program expense.

Total retirements indicated above include undepreciated work in process accruals at June 30, 2005 which were subsequently paid by the seller of the new building through escrow.

NOTE 4 - POST EMPLOYMENT BENEFITS

Pension Plans - Description

In November 2001, the Commission's board approved the implementation of an Internal Revenue Code Section 401(a) retirement plan (the Plan) effective January 1, 2002 for all Commission employees. The Plan is a defined contribution plan administered by the Unified Trust Company. The Plan is open to all employees, excluding temporary employees who work less than 20 hours per week. Currently, 48 employees are enrolled in the Plan. The Plan provides retirement benefits based on the employee's salary and years of service.

The Plan requires employer contributions of 7% of employees' annual salaries and wages. Employees vest 100% after three years of employment service. Employer contributions were \$193,806 and \$195,151 for the years ended June 30, 2006 and 2005, respectively. The contribution requirements of Plan members and the Commission are established by and may be amended by the Unified Trust Company.

Deferred Compensation Plan

The Commission also offers its employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457 (457 Plan). The 457 Plan, available to all employees excluding part-time employees who work less than 20 hours a week, permits them to defer a portion of their salary until future years. The Commission contributes a dollar for dollar match on the elective deferrals to a maximum of 5% of each employee's annual compensation. The Commission's contributions were \$136,376 and \$122,321 for the years ended June 30, 2006 and 2005, respectively. The 457 Plan is administered by the Unified Trust Company. The Commission has no administrative involvement and does not perform the investing function. The Commission remits deferred compensation plan contributions to the 457 Plan Administrator every pay period.

FIRST 5
SANTA CLARA COUNTY
NOTES TO BASIC FINANCIAL STATEMENTS
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005

NOTE 5 - OPERATING LEASES

During the year ending June 30, 2005, The Commission entered into a ten year agreement to lease a facility in San Jose, CA. The lease requires base monthly payments of \$36,599 with a 3% annual escalation clause. The agreement includes an option to extend the lease for an additional five year period. Additionally, the agreement contains a purchase option for \$5,470,000 which expires one year from the commencement date. During August 2005, the Commission exercised its option to purchase this facility. As such the lease agreement ceased.

The Commission leases equipment under non-cancelable operating leases with terms of thirty-six months. Future minimum rental payments under operating leases with initial or remaining non-cancelable lease terms in excess of one year are as follows:

Year Ending <u>June 30,</u>	
2007	\$ 7,856
2008	3,113
	<u>\$ 10,969</u>

Rental expenditures for the year ended June 30, 2006 and 2005 totaled \$104,779 and \$335,739, respectively.

The Commission leases a portion of its San Jose facility to third parties under non-cancelable lease agreements which extend into the future. Minimum lease payments to be received as of June 30, 2006 for each of the next five years are as follows:

Year Ending <u>June 30,</u>	
2007	\$ 82,398
2008	29,296
2009	14,033
2010	14,033
2011	12,864
	<u>\$ 152,624</u>

Total rental income for the year ended June 30, 2006 and 2005 totaled \$86,585 and \$0, respectively.

NOTE 6 - RISK MANAGEMENT

The Commission is exposed to various risks of loss related to torts; theft of, or damage to, and destruction of assets; errors and omissions; injuries to employees; natural disasters; unemployment; and health benefits to employees. The Commission has purchased insurance to cover general liability up to \$5 million, criminal bond up to \$10 million, workers compensation up to \$1 million, and property insurance up to \$20 million.

FIRST 5
SANTA CLARA COUNTY
NOTES TO BASIC FINANCIAL STATEMENTS
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005

NOTE 7 - GRANT ENCUMBRANCES

At June 30, 2006 and 2005, the Commission's remaining commitment with grantees was as follows:

Projects	Remaining Commitment at June 30, 2006	Remaining Commitment at June 30, 2005
Early Childhood Institute	\$ 1,108,076	\$ -
Center for Learning and Achievement	-	174,579
Prenatal Home Based Visitation	-	628,733
Early Learning Initiative	-	1,257,996
Corporation for Standards and Outcomes	-	787,795
Read Aloud Collaborative	-	40,023
Art Enrichment	-	135,388
Family Court	-	236,307
East Initiative	-	383,072
Regional Partnership	-	820,997
Community Awareness	-	725,000
Miscellaneous Grants	108,828	150,000
Total	<u>\$ 1,216,904</u>	<u>\$ 5,339,890</u>

FIRST 5
SANTA CLARA COUNTY
SCHEDULE OF STATEMENT OF ACTIVITIES
BUDGET AND ACTUAL
For the Year Ended June 30, 2006

	Original Budget	Final Budget	Actual Amount	Variance with Final Budget Positive (Negative)
Revenues				
Proposition 10 taxes	\$ 21,885,900	\$ 21,885,900	\$ 23,406,400	\$ 1,520,500
Foundation and state matching grants	2,993,200	2,993,200	2,091,587	(901,613)
Investment income	2,541,700	2,541,700	2,197,111	(344,589)
Other revenue	302,000	302,000	314,250	12,250
Total revenues	<u>27,722,800</u>	<u>27,722,800</u>	<u>28,009,348</u>	<u>286,548</u>
Expenditures				
Current:				
Salaries and benefits	5,032,600	5,032,600	4,498,434	(534,166)
Supplies and services	3,053,100	3,053,100	2,246,615	(806,485)
Grant expenditures	29,759,500	30,127,300	23,571,956	(6,555,344)
Total expenses	<u>37,845,200</u>	<u>38,213,000</u>	<u>30,317,005</u>	<u>(7,895,995)</u>
Change in net assets	<u>\$ (10,122,400)</u>	<u>\$ (10,490,200)</u>	(2,307,657)	<u>\$ 8,182,543</u>
Net assets, beginning of year			<u>98,136,580</u>	
Net assets, end of year			<u>\$ 95,828,923</u>	

- 1) The above budgetary information was prepared using the same methodologies as the preparation of the government wide financial statements which include a provision for depreciation and accrued vacation expense.
- 2) Total actual expenditures in the current year were less than budget due to a reduction in the grant expenditure category. This reduction was due to total encumbered and committed grant amounts not fully realized during the contract term.

See accompanying notes to basic financial statements.

SUPPLEMENTARY INFORMATION

INDEPENDENT AUDITORS' REPORT
ON SUPPLEMENTAL INFORMATION

August 6, 2006

To FIRST 5 Santa Clara County
San Jose, California

Our report on our audit of the basic financial statements of FIRST 5 Santa Clara County for year ended June 30, 2006 appears on page 1. That audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The Schedule of Governmental Fund Balance and Statement of Revenues & Expenditures for the year ended June 30, 2006 is presented for purposes of additional analysis and is not a required part of the basic financial statements; however, are required by the California Children & Families Commission. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, we express no opinion on it.

BURR, PILGER & MAYER LLP

Burr, Pilger & Mayer LLP

FIRST 5
SANTA CLARA COUNTY
SCHEDULE OF GOVERNMENTAL FUND BALANCE
For the Year Ended June 30, 2006

Total Fund Balance	\$	89,507,469
Committed Funds		
Encumbrances	\$	1,216,904
Approved Contracts Not Yet Executed (Obligations)		28,036,349
Funds Invested in Capital Assets		6,499,445
Reserved for First 5 California Initiatives		9,367,739
Program Sustainability		30,945,572
Reserved for Local Initiatives		<u>3,333,651</u>
Total Committed Funds	\$	<u>79,399,660</u>
Uncommitted Funds	\$	<u><u>10,107,809</u></u>

See accompanying notes to supplemental schedule.

FIRST 5
SANTA CLARA COUNTY
NOTES TO SCHEDULE OF GOVERNMENTAL FUND BALANCE
For the Year Ended June 30, 2006

Basis of Presentation:

Reservations of fund balance of the governmental fund indicate that portion of fund equity which is not available for appropriation for expenditure or is legally segregated for a specific future use. Following is a description of the nature of certain reserves.

Reserve for Encumbrances - A reserve is set aside for certain contractual obligations that the Commission has with its sub-recipients in the operation of programmatic activities. These obligations in the current year do not constitute expenditures or liabilities, but once the sub-recipient fulfills certain eligibility requirements, will represent expenditures or liabilities.

Approved Contracts Not Yet Executed (Obligations) - A reserve is established for situations where the Commission has explicitly authorized and directed staff to enter into an agreement with a specified agency, but the contract has not actually been executed.

Funds invested in Capital Assets - A reserve is established for net capital assets purchased by the Commission.

Reserved for FIRST 5 California Initiatives - A reserve is established for the total future amounts the Commission will receive as part of a guaranteed county matching program.

Reserved for Local Initiatives and Program Sustainability - A reserve has been established for specific programs or projects in the current or future fiscal years which meet certain criteria and funds which are to be used for the long term sustainability of the programs.

FIRST 5
SANTA CLARA COUNTY
STATEMENT OF REVENUES AND EXPENDITURES
For the Year Ended June 30, 2006

	School Readiness	Retention Incentives
Revenue	\$ 1,188,590	\$ -
Expenses	1,710,313	917,032
	\$ (521,723)	\$ (917,032)

Basis of Presentation:

The accompanying Schedule of Revenues and Expenditures presents funds received and expensed for Retention Incentives and School Readiness programs. This presentation is a required schedule in accordance with fiscal audit guidelines issued by the state of California Children's and Families Commission. Under this presentation, revenues are recognized when all eligibility requirements are met which coincides with State apportions and revenues to the Commission and expenses are recorded when incurred.

See accompanying notes to supplemental schedule.

**INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER
FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED
ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE
WITH GOVERNMENT AUDITING STANDARDS**

August 6, 2006

To FIRST 5 Santa Clara County
San Jose, California

We have audited the accompanying financial statements of FIRST 5 Santa Clara County (Commission), as of and for the year ended June 30, 2006 and have issued our report thereon dated August 6, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing our audit, we considered the Commission's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financing reporting that might be a material weakness. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the financial statements of the Commission are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under Government Auditing Standards.

This report is intended solely for the information and use of FIRST 5 Santa Clara County and its management and is not intended to be and should not be used by anyone other than these specified parties.

BURR, PILGER & MAYER LLP

Burr, Pilger & Mayer LLP